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IN THE

Supreme Court of the United States

OCTOBER TERM, 1957

No. 978

PERSONAL INDUSTRIAL LOAN CORPORATION (now known as Beneficial Industrial Loan Corporation),

Petitioner,

—against—

KENNETH DICKSON FORGAY,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

To the Honorable: The Chief Justice and the Associate Justices of the Supreme Court of the United States:

The petitioner prays that a writ of certiorari issue to review a judgment of the United States Court of Appeals for the Tenth Circuit, entered in the above entitled case on the 19th day of December, 1956.

Opinions Below

The Order of the City Court of Salt Lake City, Utah, entered on June 13, 1955 is printed in Appendix A hereto, page 1a hereof.

The opinion of the District Court is reported at 140 Fed. Supp., page 473, and is printed in Appendix B, hereto, page 3a hereof.

The opinion of the United States Court of Appeals is printed in Appendix C, hereto, page 18a hereof, is not yet officially reported.

Jurisdiction

The judgment of the Circuit Court of Appeals was dated and entered on December 19, 1956. Rehearing was denied February 7, 1957. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254(1).

Questions Presented

I

Whether the Bankruptcy Court may compel a creditor to proceed in that court on a nondischargeable debt rather than in the state court.

II

Whether a state court determination that a default judgment against a bankrupt is based on a nondischargeable cause of action is res adjudicata and binding upon the federal courts.

III

Whether the Bankruptcy Court may properly enjoin execution on a default judgment entered by a state court based upon an alleged nondischargeable obligation, in absence of "unusual circumstances."

The Statute Involved

Section 17, sub. a(2) 11 U. S. C., Sec. 35, sub. a(2) of the Bankruptcy Act provides:

> "Section 17, a(2). A discharge in bankruptcy shall release a bankrupt from all of his provable debts, whether in full or in part, except such as * * * (2) are liabilities for obtaining money or property by false pretenses or false representations * * *"

Statement of the Case

The Respondent obtained a loan of $878.39 from the Petitioner on November 21, 1953, on the basis of a materially false statement in writing concerning his financial condition. The petitioner-lender contends that he thereby obtained money by false representations within the meaning of Section 17, a(2) of the Bankruptcy Act.

On May 18, 1954 the Respondent filed a voluntary petition in bankruptcy in the United States Court for the District of Utah in which he scheduled the unpaid balance on the debt owed to the Petitioner. The Respondent was adjudicated a bankrupt on June 15, 1954.

On February 15, 1955, while the bankruptcy was pending and prior to discharge, the Petitioner filed an action against the Respondent and his wife in the City Court of Salt Lake City, Utah, to recover the unpaid balance on the indebtedness. The Petitioner alleged that the loan was obtained on the basis of a materially false statement in writing concerning the Respondent's financial condition. The Petitioner also alleged that if the true financial circumstances of the bankrupt had been known, the loan would not have been made. That by reason of the false representations the obligation was not dischargeable in bankruptcy.

The Respondent and his wife were regularly and duly served with summons together with a copy of the complaint. The Respondent and his attorney ignored the action in the Utah State Court. On March 9, 1955, when they failed to make an appearance in that action a default judgment was rendered against them.

On April 22, 1955 the Respondent was discharged by the Bankruptcy Court and on the same day the Petitioner was served with notice of the Respondent's appeal to the District Court of Salt Lake County, Utah from the default judgment entered in the City Court.

On May 17, 1955 the District Court of Salt Lake County dismissed the Respondent's appeal from the judgment and denied his motion to restrain the Petitioner from executing on the judgment.

On June 13, 1955 the City Court of Salt Lake City, Utah, denied the Respondent's motion for an order vacating the judgment and permitting him to file an answer. In so ordering, the Court found that the Petitioner, "had properly alleged an action based upon a nondischargeable claim in bankruptcy and that the Defendants Kenneth D. Forgay and Dorothy Forgay, his wife, were duly served with process in the above entitled matter together with a copy of the complaint and were duly apprised of the plaintiff's claim as set forth in its complaint, and it further appearing to the Court that there was no inadvertence nor excusable neglect on the part of the defendant Kenneth D. Forgay which would warrant the setting aside of the said judgment heretofore entered against the above named defendants on the 9th day of March, 1955, and the Court being fully advised in the premises."

Pursuant to the judgment entered in the City Court, the Petitioner then instituted garnishment proceedings against the employer of the Respondent.

On May 25, 1955, the Respondent, having failed in his prayers in the state courts, sought and obtained from the United States District Court an order requiring the Petitioner to appear and show cause why it should not be permanently enjoined from pursuing execution on the default judgment. The motion was heard on the affidavits of the parties. On March 9, 1955, the United States District Court ordered the Petitioner to dismiss its garnishment proceedings and permanently enjoined the Petitioner from pursuing execution on the default judgment. In so ordering, the District Court abruptly refused to honor and respect the order and judgment of the Utah court.

The Petitioner took an appeal to the United States Court of Appeals for the Tenth Circuit. By an opinion handed down on December 19, 1956 that Court affirmed the decision of the United States District Court. (Appendix B, hereto.) Thus, the Circuit Court upheld the District Court in its denial of comity.

On February 18, 1957 the United States Court of Appeals, Tenth Circuit, denied to Appellants petitions for rehearing.

Questions Involved

A. The decision in this case is in conflict with the decisions of other United States Circuit Courts including decisions in the Courts of the Second, Third, Fourth and Sixth Circuits. In this case the Tenth Circuit Court condemns the practice of and has restrained the petitioner from, "bypassing the Bankruptcy Court and going into a non-record court." (P. 18a, Appendix C.) The generally prevailing opposing concept is that the effect of a discharge upon a particular debt is usually determined *outside* the Bankruptcy Court when attempt is made at collection. Various Circuit Courts have held that a creditor having a nondischargeable obligation may not only proceed with propriety in the State Court, but that the Bankruptcy Court is without jurisdiction to stay an action in a state court based upon an obligation which would not be dischargeable in bankruptcy. Varying degrees of such holdings are found in *In re Barber,* 140 F. (2d) 727 (1944, Cir. 3); *In re Hadden,* 142 F. (2d) 896 (1944, Cir. 6); *Family Small Loan Co., Inc.* v. *Mason,* 67 F. (2d) 207 (1933, Cir. 4); *In re Stephen W. Alvino,* 111 F. (2d) 642 (1940, Cir. 2); *Personal Finance Company* v. *Martinez,* 115 F. (2d) 226 (1940, Cir. 10) and *Beneficial Loan Co.* v. *Noble,* 129 F. (2d) 425 (1942, Cir. 10). This conflict in the Circuit Court decisions should be resolved.

B. The decision in this case violates the rules of comity between the State Courts and the Federal Courts. Despite

his knowledge of the proceedings and every opportunity to appear and defend, the bankrupt and his attorney chose to ignore the State Court action. After judgment had been entered against him, the bankrupt finally moved to set it aside. The Utah Court held that the Petitioner had asserted a cause of action which was not dischargeable under the provisions of Section 17, a(2) of the Bankruptcy Act and refused to set the judgment aside. The Bankruptcy Court then reversed the State Court decision and held that the pleadings in the State Court were not sufficient to allege a nondischargeable cause of action. The appropriate rule seems to be that it is too late for the Federal Court to issue an injunction after an adverse state judgment. *Otte* v. *Cooks, Inc.*, 113 F. Supp. 861 (D. Minn., 1953); *In re Devereaux*, 76 F. (2d) 522 (1935, Cir. 2).

C. The decision in this case highlights and demonstrates the unsatisfactory situation that has developed from the 1934 case of *Local Loan Co.* v. *Hunt*, 292 U. S. 234, 54 S. Ct. 695, the application of which has now become vague and uncertain. Some courts appear to have misapprehended the narrow scope of that decision (*In re Devereaux*, see n. 3, ante; *Greenfield* v. *Tuccillo*, 129 F. (2d) 854, 857 (1942, Cir. 2); *In re Barber*, 140 F. (2d) 727 (1944, Cir. 3); *In re Parkering*, 145 F. (2d) 690 (1944, Cir. 9); *Gathany* v. *Bishop*, 177 F. (2d) 567 (1949, Cir. 4)). While another group have indicated a comprehension of the applicable principles. (*Harrison* v. *Donnelly*, 153 F. (2d) 588 (1946, Cir. 8)). See *Oglebay*, in 20 J. N. A. Ref. Bankr. at 115 (1946). Cf. *In re Setzler*, 73 F. Supp. 314 (S. D. Cal., 1947). See *Oglebay* in 22 J. N. A. Ref. Bankr. at 85 (1948). The decision in the *Hunt* case has been used to accomplish almost any result that may appeal to a particular court at any given time. The principles of the *Hunt* case should be reviewed and clarified.

Argument

By its decision in this case, the Tenth Circuit has, in effect, negatived the purpose and written off the effect of Section 17 a(2) of the Bankruptcy Act. That Section provides:

> "a discharge in bankruptcy shall release a bankrupt from all of his provable debts whether allowable in full or in part except such as * * * (2) are liabilities for obtaining money or property by false pretenses or false representations, * * *"

By the great weight of authority, the State Court is the proper source of relief for a creditor holding such a nondischargeable obligation. Indeed, some Circuit Courts have actually held that the State Court is the only source of relief in such cases, ruling that the Bankruptcy Court should not make a determination as to whether a particular item of indebtedness is dischargeable. *In re Barber,* 140 F. (2d) 727 (1944, Cir. 3); *Watts* v. *Ellithorpe,* 135 F. (2d) 1 (1943, Cir. 1); *In re Hadden,* 142 F. (2d) 896 (1944, Cir. 6). It was surprising then to have the Tenth Circuit assert that the Petitioner should have come into the Bankruptcy Court, rather than to bypass that court and come into the State Court.

The Court's misconception as to which court may determine the nondischargeability of an obligation led to its error in upholding the injunction against the Petitioner. The Court should have recognized that where such a nondischargeable debt exists, and is so alleged, the prevailing rule in other Circuits is that the creditor may proceed in the State Court and the Bankruptcy Court has no jurisdiction to stay or restrain such an action.

In the case of *Family Small Loan Co., Inc.* v. *Mason,* 67 F. (2d) 207 (1933, Cir. 4), the Court said:

"• • • A court of bankruptcy may stay suits against the bankrupt not involving his property, only where same are founded upon claims from which a discharge would be a release • • • ."

In a later case of *In re Stephen W. Alvino,* 111 F. (2d) 642 (1940, Cir. 2) the Circuit Court set aside the stay which had been granted by the District Court, and said:

"The stay was proper only if the claim asserted against the bankrupt in the action in the state court was one 'from which a discharge would be a release' • • • Where the action has not been tried, the character of the claim is determined from the plaintiffs' pleading, to the exclusion of what the bankrupt may say about the claim in affidavits • • • ."

Where the action has been reduced to judgment, it is not sufficient for the Federal Court to look only to the pleadings in issuing a stay or an injunction. Then the Court should examine into the whole record and if necessary go behind the record.

Even in the Tenth Circuit the Court of Appeals has held in the case of *Personal Finance Company* v. *Martinez,* 115 F. (2d) 226 (1940, Cir. 10), and *Beneficial Loan Co.* v. *Noble,* 129 F. (2d) 425 (1942, Cir. 10) that where a creditor has alleged a nondischargeable cause of action in a State Court suit, the Federal Court may not properly restrain such a State Court proceedings.

To say the least, the effect of a discharge upon a particular debt is usually determined outside the Bankruptcy Court when attempt is made at collection. But the defense of bankruptcy is one that must be asserted, not one which must be anticipated. *In re Innis,* 140 F. (2d) 479 (1944, Cir. 7). As Professor James A. MacLachlan has put it, "an exception to a discharge is in the nature of a replication to a plea of discharge in bankruptcy" (MacLachlan on Bankruptcy, 1956). There are numerous other cases

indicating that the State Court is a proper source for the relief of a creditor holding a nondischargeable obligation. For instance, in *In re Barber,* 140 F. (2d) 727 (1944, Cir. 3) the court said:

> "Thereby parties in interest may make known misconduct on the part of the bankrupt which, if legally sufficient, will prevent him from obtaining a discharge. But whether or not that is done, creditors holding nondischargeable debts are free to press for their payment by the bankrupt regardless of the bankruptcy."

A similar expression is found in *In re Hadden,* 142 F. (2d) 896 (1944, Cir. 6).

In view of these authorities, it was surprising for the Circuit Court to say on page 6 of its opinion:

> "While Industrial was not required to come into the bankruptcy case, the normal and ordinary course should prompt it do so (sic). Although it was served with notice, it bypassed the federal court, went into a non-record state court, perhaps of somewhat higher standing than a justice of the peace court, and obtained a default judgment."

Equitable Principles Misapplied

In the present case the Court of Appeals seems to find no case which will fully justify its decision and so like some other courts seeks recourse in the vagaries of *Local Loan Co.* v. *Hunt,* 292 U. S. 234, 54 S. Ct. 695. This is not the type of case, however, that justifies the application of the indefinite and uncertain equitable principles which have been deduced from the *Hunt* case and already mentioned on page 6. The bankrupt in this case not only had an opportunity to appear and defend in the State Court action, but actually did endeavor to invoke all possible State Court remedies, after his initial default.

There can be no question but that the Federal Court has equitable jurisdiction to enforce the benefits of its decrees, including a discharge in bankruptcy. There is an error in application of those principles in this case, however, because the Respondent has had opportunity to be heard in the courts which imposed judgment against him, and the most that can be said is that if there is any failure to afford him a more complete hearing, it was as the result of his own delinquency in failing to immediately assert any defense that he may have had to the State Court proceedings.

If the Respondent had any basis for relief his remedy should have been to appeal through the state courts. After exhausting his remedy by state law he might raise any Federal question by suitable application to the United States Supreme Court. The mere fact that such procedure would be burdensome and might be beyond his means cannot be regarded as decisive, in view of the opinion in the *Hunt* case, and in view of the pre-existing practice. Upon its facts, the *Hunt* decision rests in material part upon the settled Illinois doctrine adverse to the bankrupt. It is necessary to bear in mind that in cases otherwise comparable to *Local Loan Co.* v. *Hunt* case the Bankruptcy Court has withheld intervention upon the assumption that the bankruptcy law will be correctly applied in the state courts in the absence of a showing to the contrary. (*In re Devereaux,* see n. 3, ante; *Greenfield* v. *Tuccillo,* 129 F. (2d) 854, 857 (1942, Cir. 2); *In re Barber,* 140 F. (2d) 727 (1944, Cir. 3); *In re Parkering,* 145 F. (2d) 690 (1944, Cir. 9); *Gathany* v. *Bishop,* 177 F. (2d) 567 (1949, Cir. 4).)

Lack of Comity

This case demonstrates a complete lack of comity between the State Courts and the Federal Courts. The Federal Court here first criticized and condemned the judicial system in the State of Utah by its contemptuous references to bypassing the Bankruptcy Court and going into a non-

record State Court. These courts were provided for in the judicial system of the State and presumably creditors have a right to resort to them. In this instance the bankrupt was actively represented by counsel. Both the bankrupt and his counsel saw fit to ignore the State Court action until after judgment. When they sought to set aside the judgment the State Court found they had no basis.

The Tenth Circuit Court then went on to analyze the complaint and undertook to pass judgment on its sufficiency. This is after the State Court has already held that complaint to be sufficient, and that it "properly alleged an action based upon a nondischargeable claim in bankruptcy and that the defendants Kenneth D. Forgay and Dorothy Forgay, his wife, were duly served with process in the above entitled matter together with a copy of the complaint and were duly apprised of the plaintiff's claim as set forth in its complaint, and it further appearing to the Court that there was no inadvertence nor excusable neglect on the part of the defendant Kenneth D. Forgay which would warrant the setting aside of the said judgment heretofore entered against the above named defendants on the 9th day of March, 1955, and the Court being fully advised in the premises." The Federal Court has, in effect, sat as an appellate tribunal reviewing the proceedings and final judgment of the State Court.

If a stay of proceedings were in issue the Bankruptcy Court might examine the complaint in order to determine whether or not a dischargeable debt had been properly pleaded. Had the question been raised by the Respondent in a petition to stay proceedings prior to judgment the sufficiency of the complaint alone might properly been examined. Had the complaint been found insufficient, prior to judgment, Petitioner would have an election of procedural remedies; namely, to stand on the complaint and force the Respondent to answer or to amend its complaint to state a nondischargeable debt. The proceedings, however, were not stayed, but continued on to judgment. The Federal

Court cannot properly thereafter confine itself to an examination of the complaint to test the sufficiency of the allegations of a nondischargeable debt, but must examine the entire record. The record discloses (p. 25 Transcript of Record) that the State Court did find that the Petitioner had properly alleged an action based upon a nondischargeable claim in bankruptcy and that the debt was nondischargeable. This finding is incorporated in a final judgment of a state court, and it is therefore *res judicata* in the federal court and may not be placed in controversy there. The case of *Beneficial Loan Co.* v. *Noble,* 129 F. (2d) 425 (1942, Cir. 10) is directly in point and should control if the doctrine of stare decisis has not utterly atrophied.

The facts in this decision will be to create confusion and a great deal of additional litigation in other Circuits if the conflict between it and the decisions in the other Circuits is not resolved.

WHEREFORE, this case merits the consideration of this Court, to which end this petition is

Respectfully submitted,

JACKSON R. COLLINS
LINN K. TWINEM
Attorneys for Petitioner

May 6, 1957

APPENDIX A

Order of City Court of Salt Lake City, Utah, June 13, 1955

In The City Court of Salt Lake City, Salt Lake County, State of Utah.

PERSONAL INDUSTRIAL LOAN CORPORATION,
a Delaware Corporation,

Plaintiff,

—against—

KENNETH DICKSON FORGAY and DOROTHY FORGAY, his wife,

Defendants.

ORDER.

The motion of the above named defendant Kenneth D. Forgay for an order vacating the judgment heretofore entered against the said defendant on the 9th day of March, 1955, and permitting him to file an answer in the above entitled matter, came on regularly for hearing on the 13th day of June, 1955, at the hour of 10 o'clock A. M. before the Honorable Marcellus K. Snow, one of the judges of the above entitled court. The defendant Kenneth D. Forgay had filed an affidavit in support of his motion to which Personal Industrial Loan Corporation had filed a counter-affidavit. Said affidavits being before the Court and evidence being introduced and arguments having been heard for and against the defendant's motion and it appearing to the Court that the plaintiff Personal Industrial Loan Corporation, a Delaware corporation, had properly alleged an action based upon a non-dischargeable claim in bankruptcy and that the defendants Kenneth D. Forgay and Dorothy

Appendix A

Forgay, his wife, were duly served with process in the above entitled matter together with a copy of the complaint and were duly apprised of the plaintiff's claim as set forth in its complaint, and it further appearing to the Court that there was no inadvertence nor excusable neglect on the part of the defendant Kenneth D. Forgay which would warrant the setting aside of the said judgment heretofore entered against the above named defendants on the 9th day of March, 1955, and the Court being fully advised in the premises.

Now, Therefore, It Is Hereby Ordered, Adjudged And Decreed that the motion of Kenneth D. Forgay for an order vacating and (46) setting aside the said judgment entered against the said defendants on the 9th day of March, 1955, be and the same is hereby denied.

Dated this 13th day of June, 1955.

By The Court,

.....

City Judge

APPENDIX B

Opinion of United States District Court, April 15, 1956

In the Matter of KENNETH DICKSON FORGAY, Voluntary Bankrupt No. B-137-54, Bankruptcy.

OPINION.

This is an ancillary proceeding to enjoin a judgment creditor from executing upon a judgment obtained in a state court and thereby to protect and effectuate the bankruptcy court's orders of adjudication and discharge in the matter of Kenneth Dickson Forgay, voluntary bankrupt.

The bankrupt and his wife obtained a loan from Personal Industrial Loan Corporation[1] on November 21, 1953, in the sum of $878.38. They executed a note and completed the written form prepared by the Loan Co. concerning their financial condition.

On May 18, 1954, the bankrupt filed a voluntary petition in bankruptcy in the United States Court for the District of Utah, and listed the debt owed to the Loan Co. in the annexed schedules. Adjudication followed on June 15, 1954. The Loan Co. had personal notice of the bankruptcy proceedings but entered no appearance, filed no proof of claim and interposed no objections to discharge.

While the bankruptcy was pending and prior to discharge the Loan Co. commenced action on the note against the bankrupt in the city court of Salt Lake City, Utah, and alleged also in its complaint that bankrupt made a false financial statement to induce the loan. Upon bankrupt's failure to appear in the state court proceeding, a default judgment on the note was entered in the sum of $696.18,

1 Hereinafter called the Loan Co.

together with interest and attorney's fees according to the tenor of the note. The record does not show that a trial was held, or that any competent evidence was presented to establish the alleged fraud and no findings of fact or conclusions (7) of law were prepared or filed.

The bankruptcy court entered its order of discharge on April 20, 1955. The debt owed to the Loan Co. on the note was among the bankrupt's obligations which were discharged.

Thereafter, bankrupt filed in the state court a notice of appeal and motion to restrain the Loan Co. from executing on the judgment, and the Loan Co. filed a motion to dismiss the appeal. The state court denied the bankrupt's motion and dismissed his appeal. Subsequently the bankrupt filed a motion in the city court of Salt Lake City, Utah, to vacate the judgment and to allow him to plead. This also was denied, and the Loan Co. proceeded to attach bankrupt's wages.

The bankrupt is here seeking a permanent injunction against the Loan Co. and directing it to dismiss the garnishment proceedings, on the ground that the judgment was based upon a debt which was discharged in bankruptcy. The Loan Co. contends that it was at liberty to commence the action in the state court while the bankruptcy proceedings were pending, and having alleged a non-dischargeable claim in the complaint filed in the state court and obtained a judgment thereon, the bankruptcy court has no jurisdiction to enjoin the state court proceedings.

The Loan Co. relies upon two decisions of the Tenth Circuit, Personal Finance Co. of Colorado v. Martinez[2] and Beneficial Loan Co. vs. Noble.[3]

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2 115 F. 2d 226 (CCA-10, 1940).

3 129 F. 2d 425 (CCA-10, 1942).

Both cases are plainly distinguishable from the present. In both cases the state court action was one sounding in tort for damages for fraudulent misrepresentations. In neither was the action brought upon the debtor's note.

In the case before us, the state court action is founded upon the debtor's note. The Loan Co. took a judgment on the note, which included interest and attorneys' fees as provided in the note.

(8) It is one thing to hold, as the Tenth Circuit did in Noble, that the state court judgment in the action for damages for fraud was binding upon the bankruptcy court under the doctrine of res adjudicata. It is quite another matter to hold that the state court judgment on the debtor's note, the very same note scheduled and discharged in the bankruptcy court, precludes the bankruptcy court from taking such action as may be necessary to effectuate its orders of adjudication and discharge and for the enforcement of the provisions of the Bankruptcy Act.

This is the distinction on which the court in Noble grounded its decision. There is nothing in either Martinez or Noble contrary to the decision reached here. Indeed, we think Noble supports our view, by recognizing the power of the bankruptcy court to entertain an ancillary bill in aid of and to effectuate its order of adjudication and discharge. Judge Phillips' language in the Noble case supra, 129 F. 2d 425, 427, is clearly to that effect.

"Among the granted powers of a bankruptcy court are the allowance and disallowance of claims, the collection and distribution of the estates of bankrupts and the determination of controversies in relation thereto, the rejection in whole or in part 'according to the equities of the case' of claims previously allowed, and the entering of such judgments 'as may be necessary for the enforcement of the provisions' of the Bankruptcy Act, 11 U. S. C. A. Par. 1 et seq. In respect to such matters, the jurisdiction of the Bankruptcy court is exclusive of all other courts."

Certainly we have a question here of the "allowance and disallowance of claims," and "the determination of controversies in relation thereto," and "the entering of such judgments 'as may be necessary for the enforcement of the provisions' of the Bankruptcy Act." In respect to these matters Judge Phillips says "the jurisdiction of the bankruptcy court is exclusive of all other courts."

In Personal Finance Co. of Colorado v. Martinez the court said that the suit in the state court was based upon a non-dischargeable claim and since it was a debt "from which the bankrupt would not be released by a discharge in bankruptcy, it was error to enjoin the prosecution (9) of the state court action." However, in Beneficial Loan Co. v. Noble, the court said: "A bankruptcy court has jurisdiction of an ancillary bill in aid of and to effectuate its order of adjudication and its order of discharge. It may enjoin the prosecution of an action in the state court where facts are averred and established showing that such relief is necessary to effectuate its orders of adjudication and discharge. In so far as our decision in Personal Finance Co. of Colorado v. Martinez, 10 Cir. 115 F. 2d 226, conflicts with the foregoing, it is hereby overruled." The court recognized the prevailing rule that a bankruptcy court has jurisdiction to enjoin proceedings in state courts to preserve the benefits of a discharge, and corrected any misinterpretation created by the holding in the Martinez case on that point.

The Bankruptcy Act was enacted by the Congress of the United States for the relief of the helplessly indebted citizen. Attempted encroachments upon this humane purpose by state courts have been curtailed by federal court edict and protective Acts of Congress. This purpose and meaning of the Act is stated by Justice Sutherland in Local Loan Co. v. Hunt, 292 U. S. 234 (1934), as follows:

Appendix B

"One of the primary purposes of the Bankruptcy Act is to 'relieve the honest debtor from the weight of oppressive indebtedness, and permit him to start afresh—free from the obligations and responsibilities consequent upon business misfortunes' . . . This purpose of the Act has been again and again emphasized by the courts as being of public as well as private interest, in that it gives to the honest but unfortunate debtor who surrenders for distribution the property which he owns at the time of bankruptcy, a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of pre-existing debt . . . The various provisions of the Bankruptcy Act were adopted in the light of that view and are to be construed when reasonably possible in harmony with it so as to effectuate the general purpose and policy of the act. Local rules subversive of that result cannot be accepted as controlling the action of a federal court."

(10) Prior to 1934 it had become the practice of some federal courts who had formally discharged the bankrupt to send him forth without protection against suits and executions in state courts upon debts discharged by the federal courts. The now outmoded theory that the bankruptcy court lost jurisdiction after discharge of the bankrupt is set forth in the case of In Re Boardway, D. C.[4] In that case the federal court held that it had no power to interfere with the enforcement of a state court judgment obtained on a debt which had been discharged in bankruptcy because the bankruptcy court lost its jurisdiction after the discharge.

The Supreme Court of the United States in 1934 in the case of Local Loan Co. v. Hunt, supra, reversed this trend and established the contrary one. In that case bankrupt's employer was sued in a state court by a creditor on an assignment of wages on a debt discharged in the federal

4 248 F. 364 (1918).

bankruptcy court. An injunction was sought by the bankrupt in the federal court and granted. It was held that "a federal court of equity has jurisdiction of a bill ancillary to an original case or proceeding in the same court, whether at law or in equity, to secure or preserve the fruits and advantages of a judgment or decree rendered therein . . ."

The Bankruptcy Act itself provides the basis for the rule. Sec. 2, sub. a of the Act, 11 U. S. C. A. sec. 11, sub. a, provides in part: ". . . courts of bankruptcy are hereby invested . . . with such jurisdiction at law and in equity as will enable them to exercise original jurisdiction in proceedings under this Act . . ." and Sec. 2, sub. a (15) of the Act, 11 U. S. C. A. Sec. 11, sub. a (15), invests the bankruptcy courts with the power to "make such orders, issue such process, and enter such judgments, in addition to those specifically provided for, as may be necessary for the enforcement of the provisions of this Act . . ."

(11) Inasmuch as bankruptcy courts are courts of equity in ancillary and supplemental proceedings, they may invoke injunctive powers to effectuate and activate their orders, and a general discharge is such an order. Circumstances under which the court should intervene are not limited to any given facts. Since the Hunt case the courts have repeatedly recognized the principle and have exercised it to an increasing degree.[5]

The majority of the court in Helms v. Holmes,[6] holding in favor of the creditor, relied upon the trend of the cases

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5 State Finance Co. v. Morrow, 216 F. 2d 676 (CCA-10, 1954); Seaboard Small Loan Corporation v. Ottinger, 50 F. 2d 856 (CCA-4, 1931); Holmes v. Rowe, 97 F. 2d 537 (CCA-9, 1938); Davidson-Paxon Co. v. Caldwell, 115 F. 2d 189 (CCA-5, 1940); Evans v. Dearborn Machinery Moves, Inc., 200 F. 2d 125 (CCA-6, 1953); Personal Finance Co. of Colorado v. Day, 126 F. 2d 281 (CCA-10, 1942); In re Cleapor, D. C., 16 F. Supp. 481 (1936); In re Tillery, D. C., 16 F. Supp. 877 (1936); In re Patt, D. C., 43 F. Supp. 754 (1941); Anno. 141 A. L. R. 1380-1394.

6 129 F. 2d 263 (CCA-4, 1942).

prior to the Hunt case. However, the court did recognize the modern trend of relieving the bankrupt from the harshness of the older view, and pointed out that the granting of injunctive relief by a federal court was a discretionary matter, dependent upon the facts of each case, and that there were insufficient grounds for invoking equitable relief in that case. In an excellent dissenting opinion, Judge Paul expresses the philosophy behind this modern development in the bankruptcy law, as follows:

"It is probable that this modern view of the right of a bankruptcy court to protect by injunction the effect of a discharge in bankruptcy has been inspired by the necessity of dealing with manifest injustices that have arisen rather than from any essential error in the theory of the earlier cases. The average bankrupt is a layman who has been advised that a discharge in bankruptcy releases him from his debts and who has faith in the dignity, the force and effect of a decree of a federal court. He has surrendered his property and has no means to defend himself against further litigation. It has become the custom for greedy creditors to take advantage of this situation by ignoring the bankruptcy proceedings and the order of discharge and suing on their debts in the state courts, hoping that the bankrupt, because of his ignorance and his faith in his order of discharge or because he is (12) unable to employ counsel, will fail to appear and plead the discharge or otherwise defend. And unfortunately this frequently happens. Usually these suits are brought before inferior state courts, such as justices of the peace, many of whom are layman; and even when the bankrupt appears and pleads his discharge these justices, without legal training or experience in interpretation of the Bankruptcy Act, undertake to pass upon the effect of the discharge as affecting the particular debts—usually reaching erroneous conclusions and usually adverse to the bankrupt. Every court which

deals with any considerable number of bankruptcy cases is familiar with the difficulties which bankrupts have in protecting themselves from rapacious creditors even after discharge . . ."

Every court which deals with any considerable number of bankruptcy cases is familiar with the conditions of which Judge Paul speaks. The bankrupt is broke, and cannot hire an attorney. The meagerness of his resources is such that usually he is able at best to obtain only a lawyer of mediocre ability, or one who fails to do a lawyerlike job. Bankrupt's contest against the legal resources of a loan company is bound to be an unequal one. Neither the bankrupt nor his lawyer is familiar with this field of law and both are led into the false security of a belief that while the matter is pending, the bankrupt court has exclusive charge of it. This is shown by the fact that almost always these cases arise out of defaults in the state court action. Enforcement of the default judgment penalizes the bankrupt for having faith in the dignity and power of the federal court.

But this is not all. Judges who handle bankruptcy matters find other striking aspects of this problem. Almost invariably loan company creditors contest the discharge of bankrupt upon the ground that the loan was induced by fraud and is not dischargeable. A judge comes to learn that such objections to the discharge must be scrutinized with great care. They cannot be disposed of upon affidavit. Sworn testimony subject to searching cross-examination is essential. If the loan company by-passes the federal bankruptcy court and gets a default judgment in a city court, it of course avoids such inquiry into the facts of its claim. With a choice between a federal court which makes a searching inquiry into the facts and a city court in which the loan company can obtain a default, the loan company choice of forum is easy to forecast.

Appendix B

(13) This, of course, is what occurred in the case before us. The Loan Co. claim was scheduled properly in the bankruptcy proceeding. The Loan Co. had personal notice of these proceedings. The Loan Co. chose completely to ignore the bankruptcy court. It entered no appearance, filed no proof of claim and interposed no objections to discharge.

This is pretty much to make a mockery of the Bankruptcy Act and of Judge Phillips' opinion written for the Court of Appeals for the Tenth Circuit in Beneficial Loan Co. v. Noble, supra, and particularly his language at page 427 of 129 F. 2d.

The Loan Co. in the present case is attempting to reverse the process. Judge Phillips says the allowance and disallowance of claims and the determination of controversies in relation thereto, are within the exclusive jurisdiction of the bankruptcy court. If the Loan Co.'s contention is upheld in the present case, the city court of Salt Lake City will have exclusive jurisdiction, and the bankruptcy court will have nothing whatever to do with those matters. If the Loan Co.'s view is upheld there will be no more objections to discharges filed in the bankruptcy court in cases of this kind. Loan companies will seek default judgments in the city courts.

As compelling as the foregoing reasons seem to me to be, this still is not the whole picture. Experience with these bankruptcy matters teaches a judge that the view for which the Loan Co. contends would put a premium upon the loan companies' carelessness, if not their collusion, in obtaining applications for loans which are improperly or inadequately filled out by borrowers. A loan company manager's job is to get the money out at interest. The more he (14) gets out, the more he gets paid. This affects his efficiency rating for promotion. It affects the financial success of the concern. To be sure, if he has excessive bad

debt losses they will reflect against him. But, if the lending agency manager can make loans with assurance that the borrower won't be able to get them discharged in bankruptcy, he need not be so careful about the applications. Indeed, in the event the loan turns sour, it will be better for him and his concern if there is an omission or a misstatement in the application. At the lending stage of the transaction, with every pressure upon the loan company official to make the loan, there will be an increased temptation for carelessness, and in some cases actually for collusion. Unhappily, a judge doesn't have to be on the bench of a bankruptcy court very long before he observes both.

These, then, are the reasons for close scrutiny of the objection to the discharge, and in support of the view that the bankruptcy courts' exclusive jurisdiction over the allowance and disallowance of such claims should not be circumvented.

The following are some cases, briefly analyzed, to further illustrate the principle of the wide and almost unlimited scope of facts upon which injunctive relief has been granted.

In Holmes v. Rowe, supra, the debtor was adjudicated a bankrupt while a suit on a listed debt was pending in the state court. After discharge, the creditor took judgment by default. While the bankrupt could have appeared in the state court and asked for a stay, he failed to make any defense in that court. A permanent injunction was sought and granted in federal court against enforcement of the judgment.

In Davidson-Paxon Co. v. Caldwell, supra, the debtor was adjudicated while suit was pending against her in the state court. She applied to the state court for a stay, alleging bankruptcy proceedings and that the debt was dischargeable. The state court held the debt non-dischargeable and judgment was granted. After her discharge the debtor applied to the bankruptcy court for an injunction.

The court held the debt was dischargeable and granted the injunctive relief.

(15) In re Cleapor, supra, the creditor, aware of the bankruptcy proceedings ignored them and brought suit in a state court before a justice of the peace after discharge had been granted to the bankrupt. Upon application for injunction, the bankruptcy court held that the validity, amount and enforcement of securities was for the exclusive determination of the bankruptcy court.

In re Tillery, supra, prior to adjudication, the bankrupt was sued for automobile accident damages. Default judgment was taken on a complaint for "willful and malicious" injury. The debtor then went into bankruptcy, and the judgment creditor ignored the bankruptcy proceeding. The federal court granted an injunction after a determination that the debt was dischargeable.

In Seaboard Small Loan Corporation v. Ottinger, supra, the court unhesitatingly issued an injunction against a creditor, who, after adjudication of the debtor as bankrupt undertook to enforce a prior assignment of wages. This case stands solidly for the rule that the primary objective in all these proceedings is to protect the debtor in his rights inherent in a discharge in bankruptcy.

As previously set forth, the adjudication in this case in the bankruptcy court took place on June 15, 1954, and every proceeding in the state court took place thereafter. The indebtedness sued upon in the state court was listed in the schedules and the suing Loan Co. had notice thereof. Without availing itself of the facilities of the bankruptcy court the Loan Co. filed a suit in the state court. The primary allegation of the complaint was the balance due on the note and for interest and attorney's fees according to its terms. The complaint also set forth an allegation of fraud as follows: "At the time of securing said loan the defendants executed in writing a materially false state-

ment raising their financial condition . . ." The prayer asked for judgment on the note.

The bankrupt failed to defend in the state court and defaulted while relying on the proceedings in the bankruptcy court to protect him against the suit in the state court. At that time he had no order of discharge in the federal court to interpose in the state proceeding. Default judgment (16) was taken against the bankrupt. The record shows that the judgment prayed for and granted was upon the note and not for damages growing out of fraud.

Is the bankrupt entitled to injunctive relief from this court under all of the facts and circumstances of this case? We think the answer is clearly yes.

A case very similar to the facts of the present is State Finance Co. v. Morrow, supra. In that case a loan company commenced suit in a state court on a note after the debt thereon had been discharged in a bankruptcy proceeding. The bankrupt immediately instituted ancillary proceedings in the bankruptcy court to enjoin the action in the state court. The loan company then alleged that in reality the suit was based on a false financial statement. The federal court granted the stay on the ground that the suit was based upon the discharged debt and not upon fraud. The court of appeals affirmed. Speaking for the court, Judge Murrah said: "The suit in the state court is upon the note scheduled in the bankruptcy proceedings, and the loan company prays judgment upon it. It now says that although the complaint is upon the note, liberality of pleadings in the justice of the peace court allows it to rebut any defense of discharge by a showing of fraud in the procurement of the note.

"The debt on the note has been discharged; only the liability for fraud survives the discharge. As a practical matter based upon the realities of the judicial processes in a court in which the issues are so loosely cast, the bank-

ruptcy court is unable to determine with any degree of satisfaction whether the ultimate judgment of the court will be based upon the debt for which the note was given or the fraud which may have induced it. The court may well have taken judicial notice that the court in which the liability was asserted was not a court of record where issues of law and fact are defined with any degree of particularity, and that for all practical purposes the bankrupt was defenseless. It is these practical considerations which prompt bankruptcy courts to exercise their equitable protective powers. Indeed, it is these considerations which impose upon them the inescapable duty to vouchsafe the integrity of their decrees.

(17) "The trial court determined the adequacy of the remedy upon the face of the complaint and concluded that the Appellant's suit was upon the discharged debt. We think the trial court was fully justified in so doing."

In the Morrow case the court had only the complaint filed in the state court before it to determine the grounds upon which judgment was sought. In this case the court has before it a judgment entered by the state court which judgment is upon the note and not upon fraud and the debt evidenced by the note has been discharged in a bankruptcy proceeding.

The state court has neither heard evidence on the question of dischargeability of the claim nor entered a decree declaring the claim to be non-dischargeable.

Strong additional reasons support our view. The Act itself provides that it shall be administered by the federal courts. Every orderly and needful remedy and proceeding are provided in the Act. Protection to the debtor, creditor and the public are all provided. The division of judicial administration weakens the Act and confuses its administration. With orderly procedure and complete jurisdiction available, it can be relied upon by the worthy debtor to

protect him against embarrassment, surprising and harassing proceedings and the expense of a multiplicity of unnecessary suits. The public and the creditor are protected against the discharge of the unworthy debtor.

A creditor who has notice of the adjudication of his debtor in bankruptcy in a proceeding wherein his claim is listed in the bankrupt's schedule and who wholly ignores the bankruptcy proceeding, has himself in effect defaulted. A creditor who so ignores the bankruptcy court and who seeks to pursue his remedies in the state court manifestly is circumventing the bankruptcy proceedings. He obtains an advantage over the other creditors of the bankrupt. If one creditor ignores the notice of the bankruptcy court (18) and seeks his remedy in the state court claiming fraud, why not all creditors? This conduct on the part of creditors, if encouraged, portends the disintegration of the bankruptcy system and its orderly administration. There is no justification for federal courts to abdicate their authority to the state courts, jeopardize the *usefulness* of the Bankruptcy Act, permit the confusion and harassment of the honest debtor, give advantage to the unscrupulous creditor and contribute to the lack of public faith in the proceeding itself.

In the final analysis the decision of cases of this kind rests within the sound discretion of the court. In no case since Local Loan Co. v. Hunt, supra, has the discretionary power of the court to grant or deny the injunction in cases of this nature been questioned. On the contrary, the principle has been repeatedly affirmed.[7]

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7 State Finance v. Morrow, supra; Holmes v. Rowe, supra; Davidson-Paxon v. Caldwell, supra; Pepper v. Litton, 308 U. S. 295 (1939); Personal Finance Co. of Colorado v. Day, supra; Evans v. Dearborn Machinery Movers, Inc., supra; Helms v. Holmes, supra; In re Devereaux, 76 F. 2d 522 (CCA-2, 1935).

Appendix B

Judgment is in favor of the bankrupt. The permanent injunction is granted. His counsel is directed to prepare formal findings, conclusions and decree.

Willis W. Ritter
Judge

Filed April 15, 1956.

APPENDIX C

Opinion of United States Court of Appeals, December 19, 1956

UNITED STATES COURT OF APPEALS

TENTH CIRCUIT

Number 5426

November Term, 1956

PERSONAL INDUSTRIAL LOAN CORPORATION, now known as Beneficial Industrial Loan Corporation,

Appellant,

—v.—

KENNETH DICKSON FORGAY,

Appellee.

Before:

BRATTON, *Chief Judge,* HUXMAN and PICKETT, *Circuit Judges.*

Appeal from the United States District Court for the District of Utah, Central Division.

MACOY A. McMURRAY (McKay, Burton, McMillan and Richards were with him on the brief) *for Appellant;*

No appearance for Appellee—Brief by JOSEPH W. BOONE.

Appendix C

HUXMAN, *Circuit Judge*:

The appellant Personal Industrial Loan Corporation, herein called Industrial, has appealed from a judgment permanently enjoining it from pursuing execution on a default judgment it obtained against appellee Kenneth D. Forgay in the City Court of Salt Lake City, Utah. In addition, the judgment directed it to dismiss garnishment proceedings against Forgay's employer.

The facts essential to consider are these. Forgay filed a petition in bankruptcy in the Bankruptcy Court of Utah. He listed Industrial's claim among his debts. Notice of the pendency of the bankruptcy proceedings was duly served on Industrial. It ignored the proceedings and instead of filing its claim filed its action in the City Court, alleging that its debt was non-dischargeable in bankruptcy because of the false financial statement inducing the loan. Although served with summons, Forgay made no appearance and a default judgment was rendered against him. After this default judgment, Forgay obtained a general discharge in the Bankruptcy Court. Thereafter Forgay prosecuted an appeal from the City Court judgment to the District Court. His appeal apparently was dismissed because taken out of time. Thereafter he filed a motion in the City Court to vacate its judgment which was denied. When thereafter Industrial attached his wages he instituted this ancillary proceeding to enjoin the City Court's judgment.

It is the well settled law that the bankruptcy court has the power to effectuate the adjudication and order made by the court in a bankruptcy proceeding. This power is a continuing power and may be invoked after order of discharge and after termination of the bankruptcy proceeding in the bankruptcy court.[1] The court has a continuing

1 *Local Loan Co.* v. *Hunt*, 292 U. S. 234;
State Finance Corp. v. *Morrow* (10th Cir.), 216 F. 2d 676;
Holmes v. *Rowe*, 97 F. 2d 537.

duty and solicitude to see that a discharged bankrupt is not unduly denied the benefits of his adjudication and discharge.

The power to enjoin proceedings in a state court involving a debt listed in the bankruptcy proceedings or a judgment obtained on such a debt in a state court, either during the bankruptcy proceedings or thereafter, is not an absolute power and may be exercised only under such conditions as appeal to the equitable conscience of the court. This is so because a general discharge in bankruptcy does not wipe out the debt, it only raises a bar to actions thereon in state courts and must be pleaded and, if not pleaded, is waived and in such case a judgment in the state court is res judicata and is binding on the federal court.[2] Neither may the federal court enjoin the action in the state court or a judgment based thereon because when thereafter the matter is called to its attention in an ancillary proceeding it is of the view that the debt was in fact dischargeable. A due regard to our dual system of courts requires a federal court to conclude that, had the debtor presented the defense that the debt sued on in the state court was in fact dischargeable, the state court would have given it the consideration it merited, or that if the defense was offered and rejected by the state court that it acted in good faith and that therefore its judgment was entitled to full faith and credit.

As pointed out in the *Hunt* case by the Supreme Court and the *Morrow* case by our Court (footnote 1) as well as in a great number of other cases, the equitable jurisdiction to interfere with state proceedings involving debts pending while the bankruptcy proceedings are in progress or with judgment thereafter entered in the state courts is a qualified power and may be exercised only under such

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2 8 Remington on Bankruptcy, Henderson, 1955 Ed. §3225, p. 47; §3239, pp. 69-70;
Helms v. *Holmes* (4th Cir. 1942), 129 F. 2d 263.

circumstances as will appeal to the conscience of the court. We think the facts in this case bring it within that principle and that the judgment of the trial court is correct. We are dealing here with a finance company engaged in making small loans to debtors generally in distress when they apply for such loans. As observed by the Court in *In Re Caldwell,* 33 F. Supp. 631, 635, "If creditors, with their expert credit men, were as diligent in investigating the responsibility of applicants for credit and as prudent in bestowing it, as they are persistent and sometimes oppressive in attempting to collect after the indebtedness has been incurred, there would be fewer claims of fraud and attempts like this to defeat a discharge in bankruptcy," and we might add by bypassing the bankruptcy court and in going into a non-record state court.

While Industrial was not required to come into the bankruptcy case, the normal and ordinary course should prompt it do so. Although it was served with notice, it bypassed the federal court, went into a non-record state court, perhaps of somewhat higher standing than a justice of the peace court, and obtained a default judgment. An examination of the complaint in the State Court leads to the conclusion that the cause of action stated was predicated upon the debt and not upon fraud. The default judgment it obtained was merely for the amount of its claim and did not purport to be a fraud judgment. In fact, the judgment did not refer to fraud in any way.

Nor do we think that a valid default fraud judgment could have been entered in that case upon the allegations of the complaint. The petition in our opinion was not sufficient to state a cause of action sounding in fraud. In *Fillmore* v. *Kelly,* 220 Pac. 1064, 1066, the Utah Court said: "It is elementary that fraud must be alleged by distinctly pleading the facts constituting the fraud. Mere epithets, or conclusions or general charges . . . are not good unless accompanied with a statement of the facts to sustain it . . .

Appendix C

It is necessary to show not only what the fraud was, and that injury has been sustained, but also the connection of the fraud with the alleged damage, so that it may appear . . . whether the one might have resulted directly from the other." No facts were pleaded which if admitted or established would support a fraud judgment. All the petition alleged was that "At the time of securing said loan the defendants executed in writing a materially false statement raising their financial condition; . . . " and then after alleging Forgay had been adjudicated a bankrupt it concluded that "the claim of plaintiff herein is not dischargeable in the bankruptcy." This was not an allegation of fact. It merely stated the pleader's conclusion. By failing to appear and permitting a default judgment to be entered, Forgay admitted only facts well pleaded.[3] We think the facts of this case bring it squarely within our decision in the *Morrow* case, *supra,* and that appellant has no fraud judgment. This conclusion is not in conflict with *Personal Finance Company* v. *Martinez,* 115 F. 2d 226, and *Beneficial Loan Company* v. *Noble,* 129 F. 2d 425 by our Court, relied upon by Industrial. In the *Martinez* case the petition in the state court alleged specific fraudulent facts establishing fraud, and in the *Noble* case the state court apparently explicitly adjudged fraud on a petition clearly stating fraud.

The Supreme Court in the *Hunt* case and this Court in the *Morrow* case point out that a bankruptcy court in considering whether it should exercise its equitable discretion should give special attention to small debtors to the end that they are not harassed by being dragged through expensive state court proceedings. It is urged here that appellee had not exhausted his remedy in the state courts by failing to appeal from the judgment in the city court overruling

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3 *Brumbaugh* v. *Wilson* (Kan. 1910), 107 Pac. 792, 794; *Utah Ass'n of Credit Men* v. *Bowman* (Utah 1911), 63, 67.

its motion to vacate its judgment. Such a proceeding would entail delay and costs which the discharged debtor could ill afford and, as pointed out in the *Hunt* case, would in a large part deny him the benefits of an adjudication by the bankruptcy court.

AFFIRMED.